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Mr. David S. Guzy
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Dear Mr. Guzy:

After reviewing the "Further Supplementary Proposed Rules", I am deeply concerned that adoption of these rules will only exacerbate the problem and leave MMS in a regulatory morass. Having taught courses on energy economics and regulatory economics here at Texas A & M and elsewhere, I know a case of regulatory failure when I see it. My textbook, Energy Economics and Policy paints a graphic picture of price controls and entitlements. Furthermore, much of my published research has dealt with oil prices. You may recall seeing OPEC Behavior and World Oil Prices, which I edited with David Teece. I offer these comments representing only myself.

I assume that these changes are being proposed by the MMS in the good faith belief that the 1988 rules for valuation of royalty oil production are in need of clarification and revision. My comments on the proposed rule are not intended as a criticism of the authors; they are intended to provide insight into flaws in the critical underlying assumptions which are apparent to me as an economist with decades of experience in the oil and gas industry.

The authors argue that there are two fundamental problems prompting modification of the earlier rules–lack of competition and lack of price transparency. The premise that there is a lack of competition is wrong and has serious implications for their proposed remedy. Unfortunately, their diagnosis of the "disease" motivates their "regulatory medicine". The authors set forth the textbook model of the perfectly competitive market and then conclude that since all of its conditions are not satisfied, the market is "not competitive". Such logic demonstrates a lack of understanding of economic reasoning because even though all the conditions of the textbook ideal are rarely satisfied, the predictions of the competitive model describe reality in a wide variety of markets. Crude oil and natural gas production in the U.S., both offshore and onshore, has always been described in the academic literature as a basically competitive industry. Transaction cost considerations–not the lack of competition-- cause oil producers to dispose of their oil further down the distribution chain from the offshore platform. Transaction costs, which depend on each producer's extent of vertical integration, animate the choice of where along the chain they choose to sell their production. Merely because market transactions occur at

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points B, C, and D, but not at A does not allow us to conclude that the market is *non-competitive*. At most, this can only lead to the inference that the market price at A is *not transparent*. As discussed below, the issue of transparency is easy to remedy.

Nevertheless, based on the mistaken belief that the market price at the lease is not known and *not knowable* (because of the mistaken belief that the market is not-competitive), the authors prescribe a big dose of traditional public utility regulation. They propose a set of complicated rules for taking observed market prices at points B, C, or D and then subtracting out the "actual" transportation costs incurred after the oil leaves the offshore platform to arrive at a hypothetical price at A. The procedures for computing such costs have all the trappings of public utility regulation. Imagine the disputes over allowed rates of return, historical versus fair market value of capital, valuation of onshore storage and other facilities, etc. Clearly this will be a boon for the lawyers and yes, economists too. Rent seeking and rent defending will be the name of the game.

The critical question is whether there are viable alternatives. I am convinced there are. My policy prescription is 180 degrees opposite the authors. My solution is to make greater use of markets to reveal prices at or nearby the offshore platform and thereby overcome the issue of price transparency. In this vein, there are several possible solutions. The first and simplest is for the MMS to take its royalty-in-kind and simply sell it at the first widely accessible transportation point such as the first inlet to a common carrier pipeline. Given the large number of potential buyers, such a program would efficiently generate a transparent price under competitive market conditions. Alternatively, if the MMS thought that it would be too administratively cumbersome to take all royalty oil in kind, it might designate certain blocks as representative of different areas of the Gulf and different crude qualities. These prices could serve as benchmarks for other royalty oil marketed by the operator. Yet another variant is to use the prices revealed in several of the companies' competitive bid programs as benchmarks.

An important advantage of using the market to provide price transparency is that it will allow the MMS to utilize its administrative staff to monitor such sales and examine more closely pipeline transportation rates. Clearly, the bid prices in these offshore sales will depend on applicable pipeline tariffs.

Finally, I wish to comment on another implicit theme underlying the proposed rules. It is the notion that a vertically integrated firm is obligated to provide the MMS all of its downstream services at its cost. Stated differently, under the MMS rules, the value added downstream of the lease by a vertically integrated firm should accrue to the MMS. This would be analogous to attributing all the farmer's value added back to the manufacturer of the seeds. It is clear to me that royalties are defined at the lease level and that the value added from transporting , aggregating, and marketing the oil at downstream locations are separable economic functions distinct from the discovery and production of the crude oil. To the extent that non-vertically integrated firms can avoid such "taxes", the proposed rules would have the unintended effects of discouraging vertical integration even though it has evolved as an efficient organizational structure.

In sum, I am extremely disappointed with the authors' proposed rules. Rather than fostering and facilitating market institutions to reveal offshore platform prices, they propose a regulatory model that evolved in the 1930's and has since been discarded in a variety of industries. If history teaches us anything, it is that public-utility type regulation of markets that could otherwise function as competitive markets is extremely inefficient and counterproductive. If my ideas are appealing to you, I would be glad to meet with you informally and offer my thoughts on the details.

Sincerely,

James M. Griffin